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DISCUSSION PAPER

Growth for Europe – Is the Juncker Plan the answer?

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Executive Summary

The euro area is still suffering from low growth and high unemployment. For the recovery to become a reality, there needs to be a balance between fiscal discipline, supply side improvements and actions aimed at stimulating demand and growth. Increasing investment, both private and public, are important components in overcoming the recession.

This becomes especially clear when comparing investment dynamics during the crisis with pre-crisis levels. Total investment is still much lower than before the crisis and public investment is well below its pre-crisis peak as well.

In late November 2014, European Commission President Jean-Claude Juncker submitted a long-awaited proposal for a European Investment Plan that aims to stimulate private investment. Apart from the creation of the new European Fund for Strategic Investment (EFSI), through which private investors will receive public guarantees, the investment plan also aims to provide project assistance and improve the Single Market by removing sector-specific or other financial barriers to investment.

While generally perceived as a first positive step towards increasing private investment, some commentators have expressed reservations about the plan. These include, among others, the lack of fresh money for the initial contributions to EFSI. Since a substantial amount of these contributions is reshuffled from other places in the European budget, the question was raised whether EFSI can fund additional projects or just replicates investment projects that would have happened without the plan. Other criticism relates to the high estimate of the expected leverage ratio of 1:15, and to the risk that the plan will only have a limited impact on stressed economies.

The Juncker Plan addresses private investment, but so far there really is no clear strategy to stimulate productive public investment on the European and national level. Countries with fiscal space are reluctant to engage in higher spending, while those willing and in need of it the most are restricted by the rules. Member States and the Commission should therefore discuss options for further improving the euro area's economic governance.

In addition to urging countries with fiscal space to increase investing in national public goods, investment could be treated with budget flexibility. One could, for instance, upgrade the importance of public

investment in the European Semester. Additional deficit granted for public investment purposes could be attached to certain Country-Specific Recommendations. Another solution would be to allow some form of budget flexibility, such as the formulation of a new Golden Rule for productive public investment becoming part of the Stability and Growth Pact's application. Besides relying on a larger amount of flexibility in the rules, the Financial Transaction Tax (FTT) could be another solution to fund investment in European public goods.

It will also be necessary to overcome the mistrust among Member States that is preventing further action. The political bargain of stronger conditionality, such as through contractual arrangements, could improve the situation. Increased trust will also be an important condition for tackling long-reaching economic governance reforms such as the creation of a Fiscal Capacity, which could take the form of a macroeconomic shock insurance. Such a Fiscal Capacity could make a real difference in providing the necessary funding to maintain productive public investment, even in times of deep recessions.

The proposals presented do not attempt to be conclusive, but shall rather be an input for a wider debate on how to increase growth and employment in Europe. The paper draws heavily on the discussion of a Workshop on Growth and Investment, which the European Policy Centre (EPC) hosted on 10 December 2014 under Chatham-House Rule, with a group of economists and representatives from the European institutions.

Introduction

The current one-sided strategy of combining fiscal consolidation and structural reform to improve market confidence and restore competitiveness, thereby leading Europe to economic recovery, has proven to be insufficient. It is now clear that there needs to be a balance between fiscal discipline, supply side improvements and actions aimed at stimulating demand and growth especially since the euro area is still suffering from low growth and high unemployment, which is leading to political challenges. What the European economy desperately needs are economic impulses that can increase growth and prosperity. Monetary policy alone cannot drive the recovery. Aware of its limitations, European Central Bank (ECB) President Mario Draghi, for instance, notes that¹:

Monetary Policy alone [...] cannot overcome financial market fragmentation in the euro area. Fragmentation across national borders also reflects underlying imbalances and institutional deficiencies. Overcoming these require determined structural reforms on the side of national governments to improve the business environment and setting incentives to invest, with the aim to boost productivity, create new jobs and raise the growth potential of the economy.

Thus, structural reforms' focus should be on raising growth potential, not on fiscal consolidation. But further action is needed. Some commentators have stressed that stimulating consumption could be a way to go, given that the stronger recoveries in the US and also the UK were predominantly driven by strong domestic household consumption. Raising wages in surplus countries, especially Germany, could indeed be a way to increase euro area consumption. Legrain (2014), for instance, advocates to put a stop to the current period of German wage restraints, with today's real wages being lower than in 1999 while productivity has increased by 17.8%. Not only would raising wages in Germany increase consumption but it would also be a contribution towards reducing euro area differences in competitiveness.

Part of a comprehensive growth strategy should also encompass further action to increase private and public investment. In late November 2014 European Commission President Jean-Claude Juncker submitted the new Commission's proposal for a European Investment Plan that aims to stimulate private investment. The plan is a first step to close the large investment gap that the eurozone has built up since the crisis. However, what is missing so far is a clear plan or strategy for stimulating productive public investment at a

European and national level. Countries with fiscal space are reluctant to engage in higher spending, while those willing, and in need of it the most, are restricted by the economic governance rules. A modern European version of a New Deal could be the answer, with a focus on large-scale investment in public goods.²

The remainder of the paper will first provide some reasoning for increasing private and public investment. Then a first preliminary assessment of the Juncker Plan will be made, followed by several proposals for increasing growth through higher public investment. The Discussion Paper also takes into account recent developments underway to implement the Juncker Plan as well as further highlights some of the recommendations on increasing investment that the EPC has featured in the past.

The proposals presented do not attempt to be conclusive but shall rather be an input for a wider debate on how to increase growth and employment in Europe. The paper draws heavily on the discussion of a Workshop on Growth and Investment, which the European Policy Centre (EPC) hosted on 10 December 2014 under Chatham-House Rule, with a group of economists and representatives from the European institutions. The opinions are therefore not necessarily those of the author of this Discussion Paper but rather reflect the wider debate of the Workshop.

The case for higher investment

Total investment in the euro area remains below its pre-crisis level; this applies to both private non-residential and public investment. Claeys, Hüttl, *et al.* (2014), for instance, estimate the total investment gap to be EUR 260 billion for the EU15 in 2014 by comparing the trend of total investment for the period 1970-2014 with actual total investment in 2014. While public investment is close to its trend value, one can observe a substantial decline when contrasting current public investment to its 2009 peak.

The investment slump during the crisis has been even more severe in stressed economies than in the core; and financing conditions have deteriorated more for SMEs than for larger corporations (see e.g. Barkbu *et al.* 2015). While the stronger than usual recession and the weak growth outlook for the euro area may explain some of the decline in investment, Barkbu *et al.* (2015) show that other factors need to be considered to fully explain the euro area's weak investment dynamics. According to their assessment these factors are 'elevated financing costs and limited access to finance as a result of financial fragmentation, high corporate leverage, and policy uncertainty' (p. 5). The Juncker Plan is therefore an important contribution to overcome some of these factors on the way to higher growth. Once growth picks up investments are also expected to recover further (Barkbu *et al.* 2015). Some Workshop participants, however, questioned whether the Juncker Plan alone will be sufficient as such an initiator.

Many participants at the Workshop also stressed that boosting productive public investment either at national level or by providing a more favourable framework at European level could also accelerate the recovery. Public investment in innovation, infrastructure or basic R&D is much needed, as there are necessary complements to private investment in these fields.³ In the energy sector, for example, public investment in energy systems and infrastructure are necessary prerequisites to attract private capital. Rather than increased government spending reducing private sector investment – known as crowding out – well-designed and targeted public investment can stimulate private investment.

Crowding out as an argument against productive public investment becomes even less credible with monetary policy operating at the zero (nominal) lower bound, *i.e.* short-term nominal interest rates are at or close to zero causing a liquidity trap. In Keynesian economics a liquidity trap is a situation where ordinary monetary policy has no effect. In normal times, when interest rates are not at the zero lower bound, fiscal policy raises interest rates, which cause private investment to fall. This form of crowding out does not occur in a liquidity trap, where fiscal policy is not going to raise interest rates.

Another argument for increasing public investment (or other public spending for that matter) is the relationship between the size of fiscal multipliers and the business cycle. Fiscal multipliers measure how an economy's income level is affected by government spending. If, for example, a fiscal multiplier is higher than one, this means that, in total, national income increases by more than the additional spending. For example, Gechert *et al.* (2015), show that fiscal multipliers are significantly higher during recessions than in normal times or boom periods. This means that every euro of additional government spending leads to a cycle of consumption and wealth creation that results in an overall higher national income. Taking stock of this fact, Wren-Lewis (2015) argues that respecting a certain chronology for tackling large negative output gaps⁴ and budget deficits would be much more effective towards restoring growth: Balancing budgets and closing the output gap at the same time is harmful. Since at the lower zero bound fiscal policy is the only effective tool to close the output gap, policy-makers should, generally speaking, deal with the output gap first. Once the recovery gains momentum and growth is restored budget deficits can be reduced.

The EU Investment Plan – Stimulating private investment

Many consider the Juncker investment plan an important change in direction.⁵ Until recently there have been no substantive efforts to address the eurozone's demand problems. The focus has rather been on supply side reforms, *i.e.* structural reforms (although the term structural is actually too broad to define the kind of reforms that have been and were supposed to be undertaken by some countries). Part of the missing demand stems from sluggish investment but low consumption has also been a problem. Addressing the public and private investment gap should therefore be seen as one component of fostering growth in the eurozone, rather than the only policy response.

The Juncker Plan is one of the first crisis efforts that mainly builds on community resources/funding and it may provide a momentum for other measures that will lead to Europe's recovery. The plan aims to stimulate private investment through issuing public guarantees, providing project assistance and improving the Single Market by removing sector specific and other financial barriers to investment. Its objective is to support investment in strategic infrastructure, improve financing conditions for SMEs and middle capitalisation companies, as well as fostering EU competitiveness.

The plan has three pillars: (1) providing financial support through the newly created European Fund for Strategic Investment (EFSI), (2) the creation of a project pipeline and provision of technical support to investors and Member States, and (3) promoting structural reform and strengthening the Single Market. Most attention in the public discourse has, however, been given to the first (two) strand(s).

EFSI will receive EU guarantees of EUR 16 billion, composed of EUR 3.3 billion from the Connecting Europe Facility, EUR 2.7 billion from Horizon 2020 and EUR 2 billion from the EU's budget margins. An additional EUR 8 billion are guaranteed from the EU budget without any pre-financing. Finally, the European Investment Bank (EIB) contributes another EUR 5 billion euro. Hence, EFSI will have an initial input of EUR 21 billion.

These funds are then leveraged by an estimated factor 15, thus, in total, the plan aims to generate EUR 315 billion of investment over the next three years (2015-17). EFSI will therefore provide a public guarantee of 1/15, or 6.7%. Out of the EUR 315 billion around three quarters (EUR 240 billion) will be dedicated to long-term investment, with the remaining EUR 75 billion going towards SME and mid-cap financing (European Commission 2014).

EFSI's governance structure will reflect the contributions made to the fund. A Steering Board will decide on the overall orientation, the investment guidelines, the risk profile, strategic policies and asset allocations of the fund. Votes are based on the size of contributions. Hence, for the moment only the European Commission and the EIB have voting rights until the fund generates other contributions, for example from Member States. An Investment Committee, which will consist of independent market experts and which is

accountable to the Steering Board, will be in charge of the actual project selection. The Committee shall ensure that projects will be viable and that the public support does not crowd out private investment. (European Commission 2015a)

Furthermore, a European Investment Project Pipeline will provide investors with knowledge on existing and future projects. The EU Task Force on Investment, which identifies key projects and potential barriers to investment has already asked Member States to submit potential projects that are supposed to fulfil the following criteria (with priority given to the second criteria): (1) EU value added; (2) Economic viability and high socio-economic returns, (3) timely execution of projects (within the 2015-17 period). On 9 December 2014, the Task Force reported that Member States have already identified 2000 potential projects worth EUR 1.3 trillion.

On 10 March, the European Council has given its approval to implement the Juncker Plan. With the European Parliament's approval expected by June, EFSI is scheduled to be operational for project financing by the end of this summer. The EIB estimates that the full system will be up and running by the end of 2015. The plan is then supposed to operate for four years, with a review after three years.

All it seems?

The Juncker Plan has been criticised for its lack in providing substantial additional money. In light of the EU's annual investment gap, EUR 21 billion seems indeed rather limited. The European Commission emphasises that the aim is to offer financing solutions that crowd-in investors. EFSI will not provide grants or subsidies but financial products that will be junior to those of private investors (European Commission 2015a), so the Plan can only be considered a success if it generates significant private investment. However, some have expressed concerns that due to the reshuffling of funding from Horizon 2020, EFSI may even provide a hindrance to long-term growth. The question needs to be raised why initial contributions to EFSI had to be taken from exactly these kinds of budget positions.

In addition, whether the investment plan will be able to attract projects that would not have happened without the Commission's new initiative, remains to be seen. The Juncker Plan really needs to be measured against the return that the EUR 21 billion in initial contributions could have achieved in its former frameworks such as Horizon 2020 or under normal EIB lending practice. It will be difficult to determine whether EFSI will be able to largely fund additional investment or if a large amount of the selected projects would have been funded by the private sector or even by national/EU money in any case. While the plan is likely to deliver somewhat higher investment, the economic impact of the Juncker Proposal may be limited if the projects miss additionality.

Furthermore, the European Commission has set itself a high benchmark. Horizon 2020, for instance, provides funding to long-term, high-return projects. The Task Force will therefore need to choose rather high-return, high-risk projects to make a real difference. The Investment Committee needs to be able to identify these types of projects. It is therefore important that the Task Force will consist of EIB experts rather than politicians.

A closer look at the project proposals that the European Commission collected from Member States further leads to the conclusion that Member States have listed those types of projects that could not be financed on national level. After receiving the project proposals, the European Commission emphasised that these project lists 'do not pre-judge financing commitments by the Commission or the EIB' (European Commission 2015a). This raises the question whether the project pipeline will consist of enough viable projects.

Other more technical criticism has been expressed towards the plan's targeted leverage ratio of 1:15. While an overall multiplier of 18 has been achieved by the EIB in the past, the decomposition of the multiplier is a novelty, which led some experts to evaluate the proposed leverage ratio as overly ambitious and unrealistic to achieve in practice. Every initial euro contributed to the fund is expected to create two

additional euros of subordinate debt. In turn, every euro of subordinated debt is then estimated to create four additional euros in senior debt through private sector investment. Thus, a total multiplier of 15 is estimated (composed as $x3 \times x5$). Although higher multipliers have been realised in the past, some Workshop participants stressed that, when these levels of leverage were achieved, the composition was different (for instance: $x6 \times x3$) and therefore the multiplier from subordinated debt to senior debt may be too high.

Geographical allocation and Member State contributions

The Juncker Plan does not specify any form of geographical allocation. The design of the mechanism could therefore disproportionately benefit specific countries or regions. Even if a sufficient amount of viable projects can be found, without any form of quota, more economically stable regions could receive the majority of projects. Investors would for instance need to take into consideration the higher political uncertainty in countries like Greece, which makes investment projects less attractive in comparison to core economies. This could lead to a weaker than hoped for economic impact in these countries that are most in need of additional economic stimulus. Part of the plan is to provide technical assistance to help private investors to identify worthy projects in crisis-ridden countries and to help governments to make their proposals more attractive (European Commission 2015a). Previous examples of such Task Forces, such as the Greek Task Force, are however no promising precedents.

The plan encourages Member States to chip in with national resources but provides rather limited incentives to do so. At the time of writing, several countries have announced to complement the plan with additional funding through their national investment banks. Germany, France and Italy will each provide EUR 8 billion and Spain pledged an additional EUR 1.5 billion. But are the funds channelled through the promotional banks additional funds or were they already dedicated to projects that would have been financed without EFSI?

Furthermore, the plan allows for Member State contributions to be neutralised with regards to their treatment in the Stability and Growth Pact. The European Commission (2015b) phrased this rather vaguely:

In the case that the reference value of a 3% deficit is not respected, the Commission will not launch an Excessive Deficit Procedure if it is due to the contribution, provided the deviation is small and expected to be temporary. When assessing respect of the debt criterion, contributions to EFSI will not be taken into account.

Project selection and risk levels

The plan has been criticised for not promoting social investment projects such as in education, and for not requiring any criteria of sustainability. For instance, EFSI could fund controversial projects such as the UK's Hinkley Point nuclear project, whose proposal has been submitted by the UK government.

However, addressing the strained financial situation of SMEs by distributing roughly one quarter of the EFSI funding to SMEs and mid-caps has been welcomed. But the plan does not provide a strong focus on investments in sectors that can create significantly higher employment. Studies⁶ have shown that around half of all newly created jobs are generated in young firms. While the majority of employment is still to be found in older companies, young firms are the only group with a positive net effect on employment. Those young firms that also exhibit a high growth potential (also known as gazelles) contribute to the creation of new jobs even more. Thus, a further focus on gazelles and venture capital, in particular in the periphery, could make the investment plan an active contributor to overcoming high unemployment levels.

While it may be in the Commission's interest to focus on 'shovel-ready' projects that will be quickly implementable so that the plan can deliver results as quickly as possible, the first wave of finance should not exclude those types of projects that need more time to be implemented but are already at an advanced

planning stage. Several commentators have even questioned the availability of a sufficient amount of 'shovel-ready' projects with the necessary risk level.

Another question in this regard is whether private investors would invest in projects that were selected by the European Commission based on the required set of criteria, such as European value added and high socio-economic return. Some Workshop participants suggested that these criteria may apply to the selection of public investment, but are irrelevant for private investors. The Juncker Plan's project selection process could also lead to competitive distortions, as the more projects of a private sector nature there are, the more uncertain it becomes whether the Investment Committee is able to select the right projects (Claeys, Sapir, *et al.* 2014).

As for the risks that the plan can cover, the initial EUR 21 billion will be subordinated to private investors debt and will thus serve as a first loss tranche. The Juncker Plan therefore allows the EIB to finance projects that it otherwise couldn't support without threatening its triple-A rating. For the moment, however, it is not clear whether the guarantee will be large enough to absorb all types of losses. EFSI projects need to have higher risk levels than the usual investments funded by the EIB and private investors. Claeys, Sapir, *et al.* (2014) suggest that EFSI should finance very risky projects because it is likely that they will not be financed in the current environment, also because the guarantee would have a larger positive effect for riskier projects. Others have argued that EFSI will not be able to shoulder enough risk. Very high-risk projects would need to be funded by the public sector instead.

Success or limited impact?

Strengthening the Single Market – the third pillar of the Juncker Plan – has so far received less attention than the other two pillars. This is probably due to the fact that this agenda is not something fundamentally new. In all fairness, the European Commission seems to be aware of some of the Juncker Plan's limitations. 'The Investment Plan will not solve all our economic problems. It will not change the whole world. But if implemented efficiently, it will change Europe in a very permanent and positive direction,' Vice-President Katainen emphasised in January (Vincenti 2015). It remains to be seen if such a limited impact will apply to the Single Market pillar. There is a risk that the actions undertaken under this third pillar become one of the many endeavours of the last years to 'complete' the Single Market.

Should this limited impact materialise, the immense amount of time and energy that this plan has already and – once EFSI will be fully operational – will have absorbed, could eventually lead to losing valuable time for overcoming the recession. Rather than providing momentum for further actions, the plan could lead to stagnation. In this regard, some commentators have argued that the creation of entirely new institutions such as EFSI is not necessary. Holland (2014) for instance stresses that the EIB could instead, in cooperation with the European Investment Fund, finance a large amount of projects that already have planning approval.

How to deliver stronger public investment?

One of the strongest criticisms expressed towards the plan has been the fact that it does not address the shortage in public investment but only improves the conditions for private investment. In this regard, some Workshop participants have stressed that an increase in public investment can only be part of national spending and may be very difficult to be carried out at the European level, given the fewer European public goods that could be invested in and the expected political resistance. Rather than granting some form of flexibility for, at the moment rather unlikely, large national contributions to EFSI, public investment, particularly including social investment such as in education, could be granted some form of budget flexibility within the Stability and Growth Pact. Given the low interest rates and the fiscal space that some Member States have, funding public goods through low-interest debt may be a more viable solution for fostering a European recovery.

The quickest and legislatively least complicated solution would be, for those Member States that have room for manoeuvre, to agree on investing more strongly in national public goods such as education, health or infrastructure. This would provide a boost to internal demand and could in turn help more fiscally restrained countries in raising their internal demand without waiting for lengthy implementation processes, such as for the establishment of EFSI. The degree to which these positive spill-overs would materialise may, however, be debatable. Some Workshop participants argued that investing in public goods in one Member State will not have a significant beneficial impact on other countries' growth. Therefore, European solutions for higher public investment would also be needed.

However, despite lacklustre growth and the apparent investment gap in the euro area, including in countries like Germany, there seems to be little prospect of this type of ad-hoc stimulus being generated. The strong focus of Chancellor Merkel's government on keeping budgets in balance – celebrating the historic achievement of the 'black zero' in the current recessionary circumstances – renders such a solution unlikely. In this regard, it seems paradoxical that despite record low interest rates Member States will not, cannot or are not granted to make use of cheap financing for public investment.

Flexibility and Golden Rule

Contrary to ad-hoc stimulus, there have been requests by many to adjust European economic governance rules to allow for more flexibility (see e.g. Schneider *et al.* 2014). One way would be to upgrade the importance of public investment in the European Semester. Additional deficit granted for investment could be attached to certain Country-Specific Recommendations. This type of provision would also strengthen the European Semester process, which has been criticised for having too little impact on Member States' policy.

Member States would then have an incentive to not reduce public investment spending in order to reach the SGP's deficit goals. This practice has been very common among European governments during the crisis despite various studies highlighting the detrimental effects on growth. Cournède *et al.* (2014) show that attempting fiscal consolidation through compression of public investments is a rather bad idea. Within 17 categories, the authors rank public investment among one of the worst choices for fiscal consolidation, with only spending on health services in kind, social security contributions, childcare and family, and education being even more inimical to economic growth. From a growth perspective, fiscal consolidation would instead be better achieved by cutting spending on subsidies and pensions or increasing property taxes. At an EPC Policy Dialogue on 24 February 2015 OECD Chief Economist Catherine L. Mann explained why governments opt for cutting public investments despite these findings: since public investment concerns no particularly strong interest group it is therefore an easy candidate for budget cuts.

Another idea about budget flexibility is the formulation of a new Golden Rule for productive public investment becoming part of the Stability and Growth Pact's application. Some Workshop participants considered that such a Golden Rule would grant countries more leeway to counter the crisis. Regarding specific proposals, Maystadt (2014) would define such a rule for countries that are subject to the deficit reduction rule, *i.e.* Member States that exceed the 60% debt to GDP ratio. The former EIB President further specifies three criteria that would need to be fulfilled to qualify for this form of flexibility: Firstly, eligible projects should be in the European interest. This may be interpreted as a way to ensure that the cross-border impact of investment projects is maximised and to create some form of area-wide stimulus. Secondly, Maystadt (2014) would include a criterion for profitability, *i.e.* to fix a minimum amount of economic return. However, if this economic return criterion also contains some requirement for including social investment, such as in education and health, this would require some European framework for measuring these social returns of public investment, something that the EPC has called for in the past (see e.g. Schneider *et al.* 2014).⁷ Thirdly, in contrast to the Juncker Plan, a criterion of some form of sustainability should be specified.

A sort of Golden Rule for investment could take other shapes as well. Some have argued that additional investment between, for instance, 1/2% and 1% could be granted as additional deficit. While this ruling

would allow Member States to dedicate more revenue towards public investment, a simple addition to the deficit threshold without any further rules would effectively lead to an increase of the 3% deficit criterion. Then Member States could just shift their expenditure without dedicating more funding to public investment. This form of discussion would then lead to a very different discussion, namely the one on softening the Stability and Growth Pact.

Some Workshop participants proposed to reduce the deficit criterion from say 3 to 2.4%, and allow for an additional 0.6% for investment spending. Such a provision would prevent a simple increase of the deficit criterion but would of course effectively decrease budget flexibility. The benefit in comparison to the current rules would be that Member States gain an incentive to either maintain or redistribute their budget priorities to more growth inducing spending, similar to the proposal to integrate public investment into the European Semester.

More flexibility in whatever form will, however, come at a price. Since the crisis, the underlying political bargain of solidarity within the eurozone always entailed some form of conditionality to comply with structural reforms and fiscal consolidation. As the Greek case shows, compliance with this trade-off has so far been mixed. For this reason, some Workshop participants emphasised that the proposal for contractual arrangements could be revived, *i.e.* some form of financial support in exchange for (investment-enhancing) structural reform.⁸ However, as we have argued in the past, for instance in Schneider *et al.* (2014), this form of enforcing conditionality could be unpopular if it is seen as a way of exerting control from the centre. Furthermore the process could easily become too bureaucratic with little real impact on economic growth, also because finding the right scale of projects may be difficult.

From an entirely different perspective on flexibility, some experts argue that there are already higher deficits granted. According to the recent European Commission (2015c) Winter Forecast, the French deficit for both 2015 and 2016 is expected to be 4.1% and so well above the 3% threshold. Some Workshop participants argued that this shows the Fiscal Compact and the rule of balanced budgets is already handled more flexibly. More fiscally resolute countries thus seem to show a silent tolerance to accept higher deficits in other countries. As long as these countries do not receive any form of fiscal transfers from the community, such as through the European Stability Mechanism (ESM), no real objection is raised. From this viewpoint, changes in the euro area's economic governance structure are therefore less necessary. It is, however, questionable if this larger fiscal space will also result in higher investment.

The euro area's fundamental political economy problem and how this is preventing higher investment

Whatever form flexibility would take, pursuing one of the above proposals would certainly be a change from the current prevailing economic strategy. The German government has been severely criticised by many across Europe for its strong position on fiscal consolidation, thereby neglecting the euro area's demand problem, including the (public) investment gap. Despite the perceived large discrepancy between austerity proponents and those demanding more economic stimulus, these positions might be balanced out if there was not a large trust issue among EU Member States. Countries like Germany, the Netherlands or Finland do not have enough faith in Italy's, France's or the periphery's ability to reform. In the latter group, there is even mistrust amongst each other. This fundamental political economy problem has so far been a strong impediment towards achieving a proper recovery.

So far the German governments, *i.e.* the last three Merkel cabinets, have only done what was absolutely necessary and unavoidable to save the euro – the bare minimum to prevent immediate disintegration. Chancellor Merkel's strategy of 'muddling through' can either be regarded as visionless or just as a reflection of a fundamental German dilemma: without sufficient trust in the capability and willingness of other euro countries to engage in reforms and to create better conditions for potential growth, there is no basis for granting more fiscal stimulus by, for instance, agreeing to create higher flexibility in the rules, which could lead to higher levels of public investment.

There is no perfect recipe but some form of conditionality could be a solution. But the most powerful impulse would probably be a better-coordinated approach between France and Italy to credibly signal their commitment to economic reform. This could stimulate the more fiscally resolute countries to be more lenient with regards to respecting the Stability and Growth Pact, or even in providing further support, for example through a Fiscal Capacity. Even though opinions may differ substantively on the necessity of structural reform – after all, Germany's track record of labour market rigidities and red tape in service markets is high – this is what Germany would need in order to feel comfortable in providing more fiscal stimulus.

The Financial Transaction Tax (FTT)⁹

Other than relying on a larger amount of flexibility in the rules, the Financial Transaction Tax (FTT) could be a way to generate substantial revenues that could be used for increasing public investment. After the breakdown of negotiations in December 2014, the prospect for realising an FTT were improved in January 2015 when negotiations between the eleven participating Member States were revived and the launch date (1 January 2016) finally decided.

However, many questions remain. The European Commission initially proposed to levy a tax of 0.1% on the exchange of bonds and shares. Derivative transactions were supposed to be taxed at 0.01%. Especially the proposition to tax derivatives was subject to intense debate between several participating countries. While being generally in favour of a European FTT, the French government has been reluctant to accept the taxation of all types of derivatives in order to protect the interest of large French banks. It is still unclear what the final taxable base of the FTT will be. Furthermore, there is still no clear agreement on the level of tax rates and the final use of the revenues.

Regarding the usage of revenues Majocchi (2014) suggests that rather than distributing FTT revenues to the participating Member States, these could go towards a European Fund for Growth and Employment. This could be a way to provide substantial funding for investment in European public goods.

A Fiscal Capacity

The proposals presented so far will not be sufficient to create a genuine Economic and Monetary Union (EMU). The current system of fiscal policy coordination, which was set out under the Maastricht Treaty, is not adequate to deal with large regional economic shocks. The Fiscal Capacity, as outlined in the Four-President-Report 'Towards a genuine economic and monetary union', which was led by former European Council President Herman Van Rompuy (2012), could be a way to improve EMU in the medium term. From the debate on the Fiscal Capacity several variations emerged; some of them could make a real difference in providing necessary funding to maintain productive public investment, even in times of deep recessions.¹⁰

One part of the debate concerns the creation of a European unemployment insurance that could for instance ensure a minimum amount of protection in case of severe economic shocks. If such insurance would have been in place before the onset of the euro area crisis it could have cushioned the severe social implications that emerged from high unemployment in Europe's stressed economies. Establishing such a form of fiscal risk sharing in the EU is, however, rather difficult due to large differences in national labour markets; so there would need to be some form of harmonisation. Furthermore, the macroeconomic scale that such insurance could achieve would be limited and the effect on mitigating regional shocks may be rather weak.¹¹ Moreover, for the purpose of maintaining public investment in times of crisis, other types of Fiscal Capacities are necessary.

Probably the best way to remedy insufficient fiscal responses in the face of regional fiscal shocks as observed in the European periphery would be to set up some type of macroeconomic insurance

mechanism. This could help to maintain productive public investment and other essential spending in deep recessions. Such a scheme could rely on a measure of the business cycle, such as output gaps. Through this measure participating Member States' payments to and contributions from the insurance mechanism could be determined.

While this could be an elegant solution to account for insufficient fiscal responses in times of crisis, operating such a mechanism in practice could be very difficult. The calculation of the output gap is subject to many uncertainties and estimates vary substantively dependant on the chosen estimation methodology, of which there are many. Furthermore, historical revision of national account data, which provide inputs for calculating output gaps, can significantly change estimates retrospectively. These uncertainties would then make calculating contributions to such a scheme difficult, especially in real-time and even more so for forecasting them.

One important characteristic for such a mechanism – especially important for its political feasibility – would be the adherence to address cyclical variations only. The insurance scheme should thus not result in unidirectional or permanent transfers between Member States. In practice this would mean that transfers exchanged via the mechanism would balance over the medium term. If we take Germany as an example, the scheme would have resulted in transfers to the German federal budget in the recession years in the early 2000s and to positive support payments during the heights of the sovereign debt crisis. Enderlein *et al.* (2013) show that Germany's net transfers to such a scheme could well have been close to zero during the period 1999-2014.

This type of Fiscal Capacity could therefore be an attractive contribution to improving EMU in the medium term. Such a stability fund would be particularly helpful to provide countries with limited fiscal space to engage in fiscal policy and to also maintain an adequate level of productive public investment. For it to become a reality it would be helpful if output gap estimates could be made more reliable as a policy indicator.

Conclusion

This paper provided an input to the current discussion on how to increase private and public investment in the euro area. Increasing investment is an important component in overcoming low growth and high unemployment in Europe as total investment is still lower than before the crisis and also public investment is well below its pre-crisis peak.

The Juncker Plan is therefore a first positive step towards spurring private investment. The success of the plan will be dependent on whether the Commission can address the reservations that were expressed towards it. These include, among others, the lack in providing substantial additional money, achieving the high leverage ratio of 1:15 or the risk that the plan will only have a limited impact in stressed economies.

Member States and the Commission should also discuss options for increasing productive public investment. In addition to urging countries with fiscal space to increase investment in national public goods, these could entail a form of budget flexibility in the Stability and Growth Pact, including some form of a new Golden Rule or an upgrade of the importance of public investment in the European Semester.

But the current focus on investment also bears a risk. During the Workshop, one participant drew a parallel between today's discussions around investment and those anticipating the Lisbon agenda devised in 2000. Back then, the buzzword used to be 'Innovation'. We know today that innovation wasn't the magic solution to all of Europe's problems. We therefore need to be wary of 'Investment' becoming the new 'Innovation'. Working further towards creating a Fiscal Capacity and on improving the euro area's current economic governance framework are two goals that need to be pursued at the same time.

In this regard, it will be necessary to overcome the mistrust between Member States, which is currently preventing further action. The political bargain of stronger conditionality such as through contractual arrangements could improve the situation. Increased trust will be an important condition for tackling further economic governance reforms such as the Fiscal Capacity.

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Endnotes

- 1 Introductory remarks by ECB President Mario Draghi at the European Parliament's Economic and Monetary Affairs Committee on 17 November 2014.
- 2 For EPC proposals on a New Deal for Europe see for instance Zuleeg & Emmanouilidis (2011) and Zuleeg (2014).
- 3 See Schneider *et al.* (2014) for a more detailed description of the complementarity of public and private investment.
- 4 Output gaps describe the difference between actual and potential output. Potential output indicates the highest level of output that can be sustained over the long run. In recessions output gaps are negative as the economy operates below its capacity.
- 5 The EPC has with its proposal for a European Investment Guarantee Scheme (EIGS) argued for a similar scheme: Using limited public funds, the EIGS could provide a form of public guarantee for private investment. For an overview see e.g. Zuleeg (2013).
- 6 For an introduction see e.g. Machado & Wilson (2014).
- 7 In this regard, the EPC is currently carrying out a project on the economic and societal returns on social investment, which is planned to be launched in the second half of 2015.
- 8 The proposal was for instance set out in the European Commission's (2013) proposal for a Convergence and Competitiveness Instrument (CCI).
- 9 For an overview of the European Commission's initial proposal for a European FTT see for instance Schneider (2014).
- 10 For a more detailed overview of the Fiscal Capacity see for instance Schneider *et al.* (2014).
- 11 For an assessment of a European unemployment insurance see for instance Wolff (2012).

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